Supreme Court, U.S.
FILED
JUL 22 1980
MICHAEL RODAK, JR., CLERK

No. 79-1876

In the Supreme Court of the United States

OCTOBER TERM, 1979

DAVID R. BLAKE AND BETTY H. BLAKE, PETITIONERS

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SIXTH CIRCUIT

MEMORANDUM FOR THE RESPONDENT IN OPPOSITION

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The principal question presented in this federal income tax case is whether royalties received by petitioner[1] pursuant to a patent licensing agreement are taxable as ordinary income, as the decision below held, or are taxable as long-term capital gain under Section 1235 of the Internal Revenue Code of 1954 (26 U.S.C.), as petitioner maintains.

The pertinent facts may be summarized as follows: In 1948, petitioner filed an application for a patent on a leveling device for tables and chairs (referred to as a "glide"), for which a patent was ultimately issued in 1955. In 1954, petitioner entered into a license agreement with

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[1]"Petitioner" refers to David R. Blake. His wife, Betty H. Blake, is a party to these proceedings solely because she filed a joint return with her husband for the years in question.

American Seating Company under which the company was granted the exclusive right to make, have made, use and sell petitioner's patented glide. The license, however, was limited to furniture and equipment in the public seating sphere for schools, churches, theatres, hospitals and the like, but excluded furniture designed for restaurant and cafeteria use. The license agreement provided for a royalty of eight-tenths of one cent on each glide sold by American (Pet. App. 2c).

In 1960, petitioner entered into an exclusive license agreement with Ever-Level Glides, Inc. to make, use, and sell petitioner's patented glide, subject, however, to the American Seating license. Royalties on this license were set at 5% of net sales. The only commercial use for petitioner's glide outside the public seating field (covered by the American Seating license) was the restaurant field acquired by Ever-Level under its licensing agreement with petitioner. Accordingly, upon execution of the Ever-Level license, petitioner retained no significant commerical rights that could be the subject of further licensing (Pet. App. 4a; 2c).

On his returns for 1969 and 1970, petitioner reported the royalties paid under both the American Seating and Ever-Level licenses as long-term capital gain pursuant to Section 1235 of the Internal Revenue Code of 1954. On audit, the Commissioner of Internal Revenue determined that petitioner's piecemeal transfers of his patent rights to American and Ever-Level did not constitute a "transfer * * * of property consisting of all substantial rights to a patent" within the meaning of Section 1235 and that, consequently, the royalties received by petitioner were not eligible for the capital gain treatment provided under that section. In a reviewed decision, the Tax Court unanimously held that the royalties paid by American

Seating were taxable as ordinary income. Petitioner did not appeal from that aspect of the decision. The Tax Court further held, however, that the royalties paid pursuant to the Ever-Level license were taxable as capital gain under Section 1235 (Pet. App. 8a-14a; 3c).

The court of appeals reversed. It held that although the license with Ever-Level accomplished a transfer of all remaining patent rights then possessed by petitioner, it did not effect, as expressly required by Section 1235 and the regulations thereunder, a transfer of all the substantial rights to the patent because petitioner previously had transferred substantial patent rights to American Seating (Pet. App. 4c-8c).

There is a second question in the case involving the accrual of damages recovered by petitioner in a patent infringement suit.

The facts pertinent to this issue are as follows: In 1969, petitioner and Ever-Level cancelled their license agreement. As part of the cancellation agreement, Ever-Level transferred to petitioner all rights to recover damages for infringement in the field covered by Ever-Level's license. Prior to the execution of the cancellation agreement, petitioner and Ever-Level had jointly sued Stewart-Warner Corporation for infringement. In 1967, a federal district court ruled that the patent had been infringed. The following year, the district court's decision was affirmed and this Court denied certiorari. In December 1968, Stewart-Warner established a reserve in the amount of $43,304 (representing royalties and interest) to cover its liability for infringing the patent. Thereafter, however, Stewart-Warner moved in the court of appeals to vacate judgment and for rehearing en banc. The court of appeals denied these motions and this Court denied a second petition for certiorari (Pet. App. 6a-7a; 3c).

In February 1970, a special master determined, after having examined 2,300 pages of testimony and 200 exhibits, that Stewart-Warner had sold 4,716,470 infringing glides of which 3,065,856 were in the field covered by Ever-Level's exclusive license. He concluded that there was no established royalty rate with respect to the glides but that a reasonable royalty would be 7% of sales. Using that rate, the master determined that petitioner was entitled to damages of $51,496.76. The master also determined that Ever-Level was entitled to damages of $131,893 for lost profits. Shortly thereafter, the entire matter was settled by Stewart-Warner's payment of $171,694.88 to petitioner (to whom Ever-Level's claim had been assigned in 1969)[2] (Pet. App. 7a; 3c). On audit, the Commissioner of Internal Revenue determined that the amount Stewart-Warner paid to petitioner in 1970 was taxable to him in that year as ordinary income. In the Tax Court, petitioner claimed that the infringement damages were accruable in 1968 (a year not before the court) because he was an accrual basis taxpayer. The Tax Court unanimously held, however, that the damages were not accruable in 1968, but were includable in petitioners' income for 1970 (Pet. App. 16a-18a). The court of appeals affirmed (Pet. App. 8c-9c).

1. The court of appeals correctly held that petitioner's transfer to Ever-Level of some, but not all, of the substantial rights to his patent did not qualify for capital gain treatment under Section 1235 of the Code. The plain terms of the statute requires that there be "a transfer * * * of property consisting of all substantial rights to a

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[2]During 1969, petitioner also received, under a settlement agreement, infringement damages of $5,000 from United Industrial Syndicate, Inc. (Pet. App. 7a; 4c).

patent." Because petitioner had previously transferred substantial patent rights to American Seating, his subsequent transfer to Ever-Level of the remaining rights to the patent clearly was not a transfer of *all* substantial rights to the patent, as Section 1235 expressly requires.

Petitioner contends (Pet. 9-15) that it is sufficient for purposes of Section 1235 that he transferred to Ever-Level all the substantial rights then possessed by him. But that argument is not only inconsistent with the plain language of the statute, but is directly contrary to the Treasury Regulations promulgated under Section 1235. These regulations (26 C.F.R. 1.1235-2(b)) provide that the term " 'all substantial rights to a patent' means all rights (*whether or not then held by the grantor*) which are of value at the time the rights to the patent * * * are transferred" (emphasis supplied). Thus, as the court of appeals properly concluded, both the statute and the regulations explicitly compel the conclusion that the transfer by petitioner to Ever-Level of his remaining rights to the patent did not qualify for capital gain treatment.

There is, moreover, no basis to petitioner's claim (Pet. 14-15) that the regulations are invalid. As this Court has held on several occasions, Treasury Regulations are presumptively valid and "must be sustained unless unreasonable and plainly inconsistent with the revenue statutes." *Commissioner* v. *South Texas Co.*, 333 U.S. 496, 501 (1948); see also *Bingler* v. *Johnson*, 394 U.S. 741, 750-751 (1969); *United States* v. *Correll*, 389 U.S. 299, 306-307 (1967). The regulations here are neither unreasonable nor inconsistent with the statute.[3] On the

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[3]Other provisions in the same regulations have been upheld on several occasions. See *Estate of Klein* v. *Commissioner*, 507 F. 2d 617 (7th Cir. 1974), cert. denied, 421 U.S. 991 (1975); *Mros* v. *Commissioner*, 493 F. 2d 813 (9th Cir. 1974); *Fawick* v. *Commissioner*, 436 F. 2d 655 (6th Cir. 1971).

contrary, they merely reaffirm the statutory requirement that there be a transfer of *all* substantial rights to the patent. Furthermore, the regulations are in accord with the legislative history of Section 1235 which indicates that Congress intended that the benefits of that statute would be available only with respect to a transfer that is tantamount to an outright sale of the patent, as opposed to a piecemeal disposition of the patent, such as effected by petitioner here. See *Fawick* v. *Commissioner*, 436 F. 2d 655, 661 (6th Cir. 1971); S. Rep. No. 1622, 83d Cong., 2d Sess. 438-440 (1954).[4]

2. The courts below correctly held that the infringement damages received by petitioner were includable in his 1970 income. The fact that petitioner is an accruable basis taxpayer does not require a contrary conclusion because income is not accruable until all events occur fixing the right to receive income. Here, all events fixing petitioner's right to receive the damage award did not occur until 1970. Moreover, even assuming *arguendo* that Stewart-Warner's liability to petitioner became fixed in 1968, the income still was not accruable in that year because the amount of its liability was not readily ascertainable prior to the time the special master

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[4]The cases cited by petitioner (Pet. 12) do not conflict with the decision below. With the exception of *Rollman* v. *Commissioner*, 244 F. 2d 634 (4th Cir. 1957), none of the cases even involved the application of Section 1235. In *Rollman*, the court held that where the taxpayer-patent holder transferred all rights to his patent to a single corporation, other than the right to grant sub-licenses without his approval, the transfer qualified for capital gain treatment. The court's conclusion there that retention of a veto power over the granting of sub-licenses was not the retention of a substantial right has no bearing on the decision in this case that a transfer of less than all substantial rights to a patent does not qualify for capital gain treatment under Section 1235.

filed his report in 1970. See *United States* v. *Safety Car Heating Co.*, 297 U.S. 88 (1936); *Gillis* v. *United States*, 402 F. 2d 501 (5th Cir. 1968); *Triplex Safety Glass Co.* v. *Latchum*, 44 F. Supp. 436 (D. Del.), aff'd per curiam, 131 F. 2d 1023 (3d Cir. 1942).

It is therefore respectfully submitted that the petition for a writ of certiorari should be denied.

WADE H. MCCREE, JR.
Solicitor General

JULY 1980

DOJ-1980-07